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SUBJECT: THE GERMAN SUBPRIME BANKING CRISIS: HAND WRINGING AND SOUL SEARCHING, BUT NO REAL ANSWERS OR DECISIONS

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THIS IS A JOINT MESSAGE FROM CONGEN LEIPZIG, CONGEN FRANKFURT, AND EMBASSY BERLIN.

¶1. (SBU) Summary: The U.S. subprime crisis continues to produce anxiety in Germany?s banking sector, but the exposure of German banks remains unclear. After the bailout of a second state-run bank, SachsenLB, in mid-August, pressure for a consolidation of Germany?s fragmented financial landscape has intensified. The role of state-influenced or state-owned banks makes this process a politically sensitive one. In the search for long-term solutions, the crisis has also triggered a debate about the need for more transparency ? of credit agencies, of banks? balance sheets, and of hedge funds -- and a more streamlined system of banking supervision. The effect on the real economy appears limited so far. However, analysts are increasingly concerned about the impact of a slowdown in U.S. growth on Germany?s export-driven economy. Some analysts caution that the real culprit lies with structural imbalances in the global economy. For now, the political climate does not appear favorable for far-reaching reform in the banking sector. End Summary.

Extra Liquidity to Troubled Banks

¶2. The European Central Bank (ECB) continues to watch German markets closely, ready to fend off liquidity squeezes by flooding the market with cheap short-term money. Along with other central banks, the ECB stepped in repeatedly over the past weeks with one-day loans totaling hundreds of billions of Euros to bring the overnight rate back down into line with its main lending rate, which at present stands at 4 per cent.

¶3. German commercial banks, however, remain reluctant to lend to each other for longer periods. On September 11, the ECB therefore offered European banks extra cash to try to cut

the cost of longer-term credit, inviting them to bid for special three-month tenders. Analysts say the size of the refinancing operation shows how worried commercial banks remain that borrowers will be unable to repay loans. Nonetheless, in a sign that short-term lending may be normalizing, the ECB drained 60 billion Euros in so-called overnight cash from the market on September 12.

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Multi-Dollar Bailouts of German State Banks
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¶4. Two state-backed banks have had to be bailed out in the course of the current crisis. In early August IKB Deutsche Industriebank AG was rescued from bankruptcy in an operation worth $4.8 billion by a group of banks led by state-owned KfW (see Reftel). Recent reports indicate losses may rise further with IKB?s ?Rhinebridge? conduit unable to place commercial papers in the market. Shortly later (mid-August), state-backed SachsenLB had to be bailed out in a $23.3 billion rescue operation. German financial watchdog Federal Financial Supervisory Authority (BaFin - Bundesanstalt fuer Finanzdienstleistungs-aufsicht) insisted on an immediate sale of the bank. On August 26, wealthy state-backed Baden-Wuerttembergische Landesbank (LBBW) took over SachsenLB. The second bail-out in three weeks of a German bank raised fresh questions about the country's banking system.

¶5. The subprime crisis precipitated, but did not

by itself cause, the sudden collapse of SachsenLB. The small size of the market in Saxony (population: 4.2 million) and indifferent management had plagued the bank for years, leading SachsenLB to begin exploring a partnership or merger with the North Rhine-Westphalian state bank WestLB or with LBBW as early as October 2005. When the extent of Sachsen?s exposure to risky loans became known, it was not long before the State Finance Minister concluded he must resign.

Structural Problems

¶6. Indeed, the current troubles highlight structural problems in the German banking sector that have been known for many years. Germany is widely perceived as an "overbanked" country; there are more banks (2200) in Germany than in the U.K., France and Italy combined. On September 3, Deutsche Bank AG CEO Josef Ackermann stated in Frankfurt that the worst of the banking crisis was over and that he did not expect far-reaching consequences for the German economy as a whole. However, Ackermann emphasized that there are far too many small banks in Germany, and called on private and public/savings banks to combine forces. Other analysts have contended that the proliferation of small and inefficient banks has reduced the profitability of all banks without measurably improving service to the customer.

¶7. As EU financial markets opened up to competition, largely due to pressure from the European Commission, banks reacted by

diversifying their portfolios and becoming more aggressive in the search for higher yields. State-backed banks, such as the bailed-out IKB and SachsenLB, eagerly participated, but as small banks lacking the expertise and clout of the big boys, they overexposed themselves to risk. ?Moral hazard? may have played a part, too, some analysts observe: officials at the state banks may have thought that no matter how reckless their behavior, they would be rescued if they got into trouble.

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Consolidation: Necessary but Politically Sensitive
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¶8. With the takeover of SachsenLB, LBBW has led the way in what will likely be an ongoing process of consolidation that is fraught with political difficulties. In addition to SachsenLB, LBBW pursued a merger with North Rhine-Westphalia?s state bank WestLB, which had suffered enormous losses in a series of bad investments unrelated to the current mortgage crisis. LBBW is competing against Germany?s second largest bank Commerzbank AG and financial investors J.C. Flowers and Cerberus. Taken with its acquisition of SachsenLB, a successful merger with WestLB would transform LBBW into Germany?s second largest bank after Deutsche Bank, with total assets of over 700 billion Euros.

¶9. State governments, however, are reluctant to give up control over ?their? bank for the benefit of another state. North Rhine-Westphalia?s government led by Minister President Juergen Ruettgers has so far refused to conduct exclusive negotiations with LBBW. Although Baden-Wuerttemberg Minister President Guenther

Oettinger has played down the potential rift (?we are not forcing ourselves on WestLB?, he said after the SachsenLB takeover), Ruettgers traveled to Munich on September 12 to sound out options with Bayerische Landesbank, Bavaria?s state bank. It?s not just about Euros and cents: Ruettgers may feel more comfortable with Bayerische Landesbank, which although sizable, would be less likely to completely dominate WestLB. The politics of state banking highlights the obstacles to consolidation in a country with a strong federal tradition.

¶10. IKB, the first bank bailed out in this crisis, is also a takeover target. The federal bank German Development Bank (KFW-Kreditanstalt fuer Wiederaufbau), which holds a 38% stake in IKB, may now be willing to sell in what seems to be an about-face by (SPD) Finance Minster Peer Steinbrueck, who after initially hesitating now says that a sale depends on ?timing and how pretty the bride looks?. Interested banks include Commerzbank, Hypo-Vereinsbank, and the U.S. private equity firm Cerberus.

Transparency and Better Supervision

¶11. Chancellor Merkel and Finance Minister Steinbrueck have called repeatedly for more transparency in international financial markets. Details are sketchy as to whether this would apply to banks, rating agencies, hedge funds -- or the entire industry. In an Embassy discussion

with Deutsche Bank Research, the bank?s Berlin representative interpreted these statements as a way of encouraging the financial industry to draw up and self-impose ?code of conduct,? rather than submit to mandatory government rules.

¶12. The institutional framework for banking supervision in Germany and Europe is also under scrutiny. In Germany, responsibility for supervising the financial sector is shared by the independent central bank Bundesbank and the Federal Financial Supervisory Authority BaFin under the auspices of the Federal Ministry of Finance. Both institutions have lived uneasily with overlapping responsibilities and guard their prerogatives closely.

¶13. Finance Minister Steinbrueck has rejected calls for abolishing Germany?s dual system saying that ?it has served us well in the past?. Some analysts have proposed replacing national systems with a unified European system of supervision that would involve central banks and independent watchdogs to varying degrees. Under Germany?s Grand Coalition (CDU-CSU-SPD) government, fundamental reform is unlikely as any decision might work to the advantage of one or the other partner, CDU or SPD, or so some observers say.

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Worries about the Impact of the Crisis on the Real Economy
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¶14. Meanwhile, concerns that the global financial crisis may affect overall economic growth in Germany and the Eurozone are increasing. The optimistic mood at the beginning of this year received a blow when both the OECD and the EU Commission revised German GDP growth downward, from 2.9% to 2.6%. Growth had already slowed in the first half of the year, both organizations emphasized, but the prevailing uncertainty was likely to drag on the economy in the second half of the year. According to the Berlin-based economic research institute DIW, the key will be whether the financial crisis and subsequent slowdown in the U.S. hit German exports.

Comment

¶15. (SBU) There is a growing recognition that Germany?s banking system must play by a different set of rules in a highly globalized financial industry where markets are quickly impacted by developments around the world. The question is what the new rules should be and whether Germany?s state banking system is up to the task of undertaking reforms that are economically necessary but politically unpalatable. The sense we get here is that these types of decisions will be postponed for as long as possible. End Comment.